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INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RHEHNSC/NSC WASHDC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 LONDON 001497

SIPDIS

E.O. 12958: DECL: 06/24/2019
TAGS: EFIN ECON EINV UK
SUBJECT: LONDON-BASED EXPERTS ASSESS SOVEREIGN WEALTH FUND ACTIVITIES

Classified By: Economic Counselor Kathleen Doherty for reasons 1.4 b an d d.

¶1. (SBU) Summary: The global financial crisis eroded the market value of sovereign wealth funds' holdings, leading many to refocus on liquidity in the short term with moves towards cash balances and fixed income government securities, especially U.S. Treasuries. However, experts with whom ECONOFFs met recently, suggested the funds were still keen on maintaining diversified portfolios and would avoid fundamentally rebalancing their portfolios. Several experts suggested one consequence of the global financial crisis might be for funds to take more activist roles, including greater participation in corporate governance. End Summary.

Building Liquidity Buffers Now

¶2. (SBU) Experts agreed sovereign wealth funds (SWFs) have been focused on liquidity since the collapse of Lehman Brothers and subsequent intensification of the global financial crisis. Andrew Rozanov, Managing Director Head of Sovereign Advisory at State Street Global Markets, recently told ECONOFFs sovereign wealth funds were refocusing on liquidity in the near term. Governments, particularly monetary authorities, underestimated the amount of dollar liquidity needed. Post the 1997 Asian financial crisis, emerging market economies became self-insured vis--vis foreign exchange reserves, by holding a larger amount of FOREX, but Rozanov pointed out massive drawndowns of reserves to combat the downturn, in countries like Russia, meant officials could become less comfortable adding risky assets to their portfolio because of the need for liquidity. Cynthia Sweeney Barnes, Global Head of Sovereigns and Supra-nationals at HSBC Global Asset Management, agreed with Rozanov's assessment and told us she saw an uptick in cash investment, particularly money market funds, following the U.S. Treasury Department's guarantee of U.S. money market funds. She also noted the adjustment back to equilibrium could take longer in the Persian Gulf states, so cash and real assets were the focus. Robert Ryan, Managing Director at Morgan Stanley, who had recently returned from a trip the Persian Gulf, told us local market watchers were not buying the green shoots theoy of economic recovery that were receiving press of late. Instead, locals in the Gulf anticipated a drawn-out recovery and funds continued to build cash balances in the short term.

¶3. (C) As further indication of SWFs' risk-averse behavior, HSBC's Barnes told us there had been a consolidation among asset managers since the onset of the global financial crisis. She asserted HSBC benefited because it was seen as more conservative. Robert Ryan, Managing Director at Morgan Stanley, told us funds, such as Abu Dhabi Investment Authority (ADIA), were demanding explanation for bad performance and even demanding managers waive fees for poor

returns.

Real Fundamental Rebalance of Portfolios Unlikely

¶4. (SBU) Guy Henriques, Head of Official Institutions at Schroeder Investment Management, and Morgan Stanley's Ryan told us during recent meetings they did not envision significant and long-lasting shifts in SWFs' portfolios because most were multigenerational funds with long-term horizons. Henriques asserted strategic asset allocation was based on performance of asset classes; fund managers had already "factored in 1930s downturn type scenarios so they would likely stick to their guns." Ryan stressed funds were working through existing positions vice rebalancing portfolios, and he expected a reallocation of assets later in the year from liquid, fixed income securities into equity. Henriques, Ryan, and State Street's Rozanov all agreed Norway,s Government Pension Fund-Global (GPF-Global) has continued to purchase equities during the current downturn--$65 billion worth--as part of its long-term mandate of a 60-40 equities to fixed income portfolio split.

Instead, Funds Likely to Maintain Diversified Portfolios
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¶5. (SBU) State Street's Rozanov asserted funds were still looking at diversification over the longer term. At a sovereign wealth-themed conference held in London in early May, Norway's GPF-Global representative cautioned against

making judgments around just one year's performance, particularly 2008, said Rozanov. The representative stressed downturns were part of the risk when entities, such as sovereign wealth funds, have long-term investment horizons versus those chasing short-term returns; long-term investment horizons kept assets exposed but the returns were to compensate for the greater risk.

¶6. (SBU) HSBC's Barnes saw signs of the flight to quality, vis-a-vis U.S. Treasuries, already abating. Funds could not sit on Treasuries for an extended period of time. Barnes also saw greater interest in real assets. She called the pursuit of physical assets by SWFs in the Middle East and North Africa "comfort" investing; for example, private equity investments tended to go towards real estate and infrastructure.

Economic Climate Favors South-South Diversification But Lack of Deep Capital Markets Present Hurdle
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¶7. (C) Experts we met agreed South-South investments (from the Middle East, Asia and Latin America to other countries within these three regions) now appeared more attractive in terms of growth prospects, but were not always possible. Gerard Lyons, Chief Economist and Group Head of Global Research at Standard and Chartered told ECONOFFs in late May the economic climate favored regional diversification towards the East, but in reality emerging markets lacked depth relative to the U.S. and UK. If the funds invested regionally, they would need to buy and hold longer term. HSBC's Cynthia Barnes and Schroeders' Henriques also told us Middle East funds would like to invest more locally but want to avoid creating inflation at home and the region lacked capacity to absorb the volume of potential investments. Morgan Stanley's Robert Ryan asserted investors interested in long-term growth in stock markets should go to emerging markets and agreed sovereign funds would like more exposure to emerging markets but questioned whether the funds were comfortable with the volatility in returns inherent in

emerging markets.

Recent Liquidations of Stakes in Financial Institutions Not Likely to Create Domino Effect
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¶8. (C) Standard and Chartered's Lyons told us the global financial crisis changed the environment for Singapore's Temasek Holdings. The fund was likely scaling back global aspirations and focusing on regional development. Lyons suggested the sale of its Bank of America stakes earlier this year reflected the refocused approach but would not lead to a spree of sovereign wealth entities liquidating their stakes in Western financial institutions. Recent press reports suggested Temasek also sold its stake in Barclays some time between December 2008 and January 2009 at a loss of $500-600 billion. From Lyon's perspective, Singapore, feeling Hong Kong nipping at its heels, was looking to regroup and strengthen its regional status. He also noted the risk of Middle East funds liquidating foreign assets seemed to have subsided because of confidence about of oil prices; oil prices have climbed back to $71 per barrel, and the funds budgeted for lower break-even point. (Comment: In late April, Qatar Holding, an arm of the Qatar Investment Authority, sold 35 million shares, lowering its original 6.4 percent stake to 5.8 percent--officials claimed it was part of its trading strategy, according to press reports. Qatar Holding still holds 488 million shares and its stake is due to increase by 326 million shares upon conversion of mandatory convertible notes before the end of June. One of Abu Dhabi's multiple sovereign investment arms, the International Petroleum Investment Corporation sold its stake in Barclays in early June for a sizable profit. This could have been a simple move to cash in on a higher share price, 256 pence per share, ahead of conversion--IPIC's stake consisted of securities with a conversion price of 153 pence per share--or one suggesting a refocus on hyrdo-carbon investing.)

Potential To Become More Involved in Corporate Governance
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¶9. (C) Several experts who met with us suggested SWFs could take on more activist investor roles. Rozanov suggested sovereign funds would become more involved on corporate governance issues, in part because of the underperformance of

major financial institutions. SWFs could pressure management without exposing the funds to political risk by engaging with peer institutions, such as large pension fund or activist hedge funds--activist hedge funds typically took take larger stakes in companies and were corporate activists. In partnering with the activist hedge fund, the SWF would be entrusting the stake to the hedge fund. Rozanov argued the political risk of engaging the hedge fund would be limited because, from his perspective, U.S. regulators seemed comfortable with non-political investing of hedge funds and private equity firms. Transparency on the part of both SWFs and hedge funds would help mitigate political risk with outsourcing to activist hedge funds. In Europe, however, working with large institutional investors who voted shares actively, like pension funds, would be more palatable even though the activist hedge fund objectives would be a better match for the SWFs, according to Rozanov. HSBC's Cynthia Barnes argued that anger over losses stemming from the on-going crisis was palpable and SWF officials have been looking at banks and asset managers to blame. Therefore, she saw the potential for fund officials becoming more involved in the details, despite the typical penchant of SWF officials to avoid courting publicity.

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